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No. 98-2043

In The

Supreme Court of the United States

HUNT-WESSON, INC.,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Writ Of Certiorari To The Court Of Appeal Of California For The First Appellate District

REPLY BRIEF FOR PETITIONER

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RULE 29.6 STATEMENT

Hunt-Wesson, Inc. is a wholly owned subsidiary of ConAgra, Inc. Its non-wholly-owned subsidiaries are ConAgra Brands, Inc. and ConAgra Limited.

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REPLY BRIEF FOR PETITIONER

Petitioner identified two, independent mechanisms by which Cal. Rev. & Tax. Code § 24344 denied it an interest deduction in violation of the Constitution: first, the statute denied petitioner an interest deduction merely because petitioner received nontaxable dividends;[1] second, the statute denied petitioner an interest deduction because those dividends were paid by subsidiaries that did no business in California. If either of these mechanisms is constitutionally infirm, petitioner is entitled to the interest deduction at issue.

Respondent's defense of the first mechanism California employs to deny petitioner an interest expense deduction – reducing its interest expense by the amount of its nontaxable dividends – is unpersuasive. The underlying theme of respondent's defense is that the interest offset is simply part of a "fair" and "rational" method for "matching" expense to income and that its constitutionality should be judged by the loose standards that this Court applies to the constitutionality of apportioned income taxes. But this defense simply ignores the undisputed facts and controlling law of this case.

First, the interest-offset provision cannot seriously be characterized as a "fair" and "rational" method for "matching" expense to income. Rather than "matching" expense to income, the interest-offset provision arbitrarily assigns a dollar of interest expense to a dollar of nontaxable income regardless of the relationship of the expense to the nontaxable income. As a consequence, the interest-offset provision will invariably attribute interest expense to nontaxable income in a different way than it attributes interest expense to taxable income. This is not "fair"; this is not "rational"; and it is not "matching."

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[1] Petitioner contended that this mechanism (1) taxes income beyond California's reach in violation of the Due Process and Commerce Clauses (Brief for Petitioner ("Pet. Br.") 18-33) and (2) discriminates against nondomiciliary corporations in violation of the Commerce Clause. *Id.* at 33-37.

Second, even assuming that "money is fungible" (Brief for Respondent ("Resp. Br.") *passim*) and that interest expense cannot be traced to particular items of income, it does not follow that any allocation of interest expense – no matter how arbitrary – can pass constitutional muster. If interest expense "cannot be reliably traced to its ultimate use," *id.* at 21, then interest expense may be allocated to a taxpayer's income by any of a variety of reasonable methods – such as those widely adopted by States other than California – which allocate interest expense between taxable and nontaxable income on a nondiscriminatory basis. What a State may not do – and what California has done here – is systematically to assign interest expense to income that the State may not constitutionally tax.

Third, there is no merit to respondent's contention that all of this is constitutionally tolerable because the interest offset's constitutionality should be determined under the relaxed standards this Court has applied to constitutional challenges to formulary apportionment of income. Under respondent's theory, any provision of a state's apportioned corporate income tax, no matter how offensive to constitutional norms when viewed by itself, is invulnerable to attack as long as the resulting apportionment does not produce a "grossly distorted result." *Id.* at 25. That is not the law. *See, e.g., Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388 (1984).

Respondent has made no serious effort to defend the second mechanism by which it denies petitioner an interest deduction – confining petitioner's interest expense deduction by reference to the in-state activities of its dividend-paying subsidiaries. Respondent does not even advert to this issue in its summary of argument, and, when it turns to the question at the tail end of its brief, respondent makes the ludicrous suggestion that "this Court is not compelled to address it" (Resp. Br. 46) because the constitutional flaw that petitioner *has* attacked can be traced to a more fundamental defect in California's taxing scheme.

On the merits, respondent's perfunctory defense of California's preference for investment in in-state over out-of-state

corporations is so weak and confusing that one understands why respondent has done its best to bury the issue. In its futile effort to distinguish *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), which invalidated a virtually identical in-state preference scheme, respondent claims that California's in-state preference may be justified by its benign purpose – the avoidance of double taxation. But this contention runs headlong into settled Commerce Clause doctrine that States may not pursue even legitimate objectives by discriminatory means. Respondent's further suggestion that the goal of avoiding double taxation "cannot be adequately served by reasonable nondiscriminatory alternatives" (Resp. Br. 48 n.29) not only concedes the essential point that the statute *is* discriminatory, but also ignores the fact that there is a readily available nondiscriminatory alternative – treating all dividends the same. And respondent's argument, repeated throughout its brief, that the interest-offset provision is constitutional because it is "internally consistent" rests on a non sequitur: While it is true that statutes that are *not* "internally consistent" are *not* constitutional, it does not follow that statutes that *are* "internally consistent" *are* constitutional. *See, e.g., New Energy Co. v. Limbach*, 486 U.S. 269 (1988) (striking down "internally consistent" reciprocity statute that discriminated against interstate commerce).

I. THE INTEREST-OFFSET PROVISION'S ARBITRARY ASSIGNMENT OF PETITIONER'S INTEREST EXPENSE TO ITS NONTAXABLE INCOME INDIRECTLY TAXES SUCH INCOME, EVEN IF ONE ACCEPTS RESPONDENT'S ERRONEOUS DESCRIPTION OF HOW THE INTEREST-OFFSET PROVISION OPERATES

A. The Interest-Offset Provision Applies Only to Business Interest Expense, and This Court Should Disregard Respondent's Eleventh-Hour Attempt to Repudiate Its Own Stipulation

The parties stipulated that "nonbusiness interest expense . . . was deducted from total interest expense" before the interest-offset computation was made and that only "business

interest expense" was "subject to the 'interest offset' computation." Stip. ¶ 11 (Joint Appendix ("J.A.") 20). Respondent now seeks to repudiate this stipulation. It contends that it never stipulated "that the elimination of nonbusiness interest expense is a *statutory* component of the interest offset computation." Resp. Br. 19-20 n.13 (emphasis supplied). Instead, it argues, the stipulation is based only on respondent's own form, which, respondent now tells us, "*erroneously* instructs the taxpayer to identify and subtract its nonbusiness interest expense" prior to the application of the interest-offset provision. *Id.* (emphasis supplied). Respondent then informs this Court that, nearly two decades after the years at issue when the form in use purportedly did "not correctly implement the provisions of the statute," respondent is "empowered retroactively to correct mistakes of law" that it made in issuing "the form in use during the years in issue." *Id.*

Respondent's eleventh-hour disavowal of its own stipulation is a transparent attempt to revise the facts of this case to its own liking. There is no foundation for respondent's revisionist view of the operation of the interest-offset provision,[2] and the provision's arbitrary operation is exacerbated by the exclusion from its scope of interest expense that is directly traceable to nonbusiness income. Nevertheless, petitioner agrees with respondent that, on the facts of this case, the

[2] Indeed, respondent's claim, contrary to its stipulation, that the interest-offset "statute is applied to *all* 'interest' expense" (Resp. Br. 5 (emphasis supplied)) and not just to "business interest expense" is belied by respondent's own assertion, in a later section of its brief, that "interest expense relating to the production of exempt dividends is denied separately as a deduction by virtue of Cal. Rev. & Tax. Code § 24425, which proscribes the deduction of any expense allocable to income not taxable by California." *Id.* at 47 n.28; *see also* Brief *Amicus Curiae* of Idaho, et al. 27. This is the very provision that constitutes the statutory basis for what respondent now claims are the "erroneous" instructions contained in the tax forms in use during the years at issue. Respondent has failed to explain how Cal. Rev. & Tax. Code § 24425 provides the statutory basis for allocating interest expense to one class of exempt dividends but not to another.

"confusion" respondent has admittedly created "is not constitutionally significant." *Id.* at 19-20 n.13.[3] The fundamental flaw in the statute – the arbitrary assignment of interest expense to nontaxable income without regard to the relationship between the expense and the income – remains regardless of whether there is any preliminary allocation of nonbusiness interest expense to nonbusiness income.

B. The Undisputed Facts Reveal That There Is No Matching of Interest Expense to Nontaxable Income and That Interest Expense Is Assigned Disproportionately to Nontaxable Income

Respondent's case rests on the premise that the interest-offset provision constitutes a "fair" and "rational" method for "matching" interest expense to exempt income. That premise is demonstrably false. During the years at issue California assigned one dollar of interest expense to each dollar of nonunitary dividend income that lay beyond its taxing power, but less than thirteen cents of interest expense to each dollar of unitary income that it could tax. *See* Appendix B.[4]

[3] In light of respondent's position that it "is not constitutionally significant" whether directly traceable nonbusiness interest is excluded from the interest offset computation, it is rather astonishing that the Multistate Tax Commission ("MTC") devotes a substantial portion of its amicus brief to this issue. Even more astonishing is the fact that the MTC's position in its amicus brief is contradicted by its own audit manual, which clearly states that in California nonbusiness interest expense is subtracted from total interest expense *before* computation of the interest offset. *See* MTC Corporate Income Tax Audit Procedure Guideline Manual, MTC Schedule 1205 (reproduced at App. 1a).

[4] In Appendix B to this brief (lines 9-10), we set forth the calculations, based on the undisputed facts of this case, that demonstrate the following: For 1980, the interest-offset provision assigned $1.00 of interest expense to each $1.00 of nontaxable dividends, but only $0.11 of interest expense to each $1.00 of taxable business income; for 1981, the respective figures were $1.00 and $0.05; and for 1982, the respective figures were $1.00 and $0.21. For all three years, the interest-offset provision assigned $1.00 of interest expense to each $1.00 of nontaxable

Nowhere does California explain why it takes one dollar of interest expense to finance the production of one dollar of income that it cannot tax but only thirteen cents of interest expense to finance the production of one dollar of income that it can tax. By what form of alchemy does borrowed money miraculously become more productive when it is used to generate taxable rather than nontaxable income? Whatever California is doing, one thing is for sure: it is not "matching" interest expense to interest income. Rather, it is arbitrarily and mechanically assigning it disproportionately to nontaxable income.

C. Respondent's Assumption That "Money Is Fungible" and That Interest Expense Cannot Be Traced to Particular Items of Income Does Not Justify an Interest Allocation Methodology That Assigns Income Disproportionately to Nontaxable Income

Respondent repeatedly asserts that "California's interest offset statute is based on the rationale that money is fungible and cannot reliably be traced to its ultimate use." Resp. Br. 21; *see also id. passim*. But this proposition does not justify the interest-offset mechanism. Even if we accept the notion that "money is fungible and cannot be traced accurately to its ultimate use," *id.* at 30, it does not follow that any methodology for assigning interest expense – even one that systematically assigns (and, in this case, overassigns) interest expense to nontaxable income – is constitutionally acceptable. Yet that, in substance, is the position that respondent has taken before this Court.

Rather than providing any justification for an interest allocation methodology that, in this case, assigns eight times as much interest expense to nontaxable as to taxable income (and thereby sweeps nontaxable income into the tax base),

dividends, but only \$0.13 of interest expense to each \$1.00 of taxable business income.

respondent says that "Hunt-Wesson fails to provide any explanation as to how or why any of the alternative methods which it has embraced more 'fairly' or 'rationally' allocate interest costs to classes of income." *Id.* at 33. But the explanation is self-evident. *Virtually all of the methods adopted by other States and the Federal Government for allocating interest when it cannot be directly traced to particular items of income do so in a manner that does not disproportionately assign interest to nontaxable income.* Indeed, the common theme of these methods is that they spread interest expense evenly over all of the income to which it is indirectly related. Moreover, California itself has embraced such an evenhanded methodology in other contexts, Pet. Br. 26-28, and, in fact, stands ready to apply such a methodology to other taxpayers that have challenged the interest-offset provision. Brief *Amicus Curiae* of General Electric Co. App. 1a-4a.[5]

As for respondent's contention that petitioner has not "offered any proof to this Court that it would have been entitled to deduct more interest expense from its business income under any of these alternative formulas," Resp. Br. 34, the reason for that failure is obvious. No amount of proof was relevant under the interest-offset provision. Even if petitioner had proved that all of its disallowed interest expense was directly traceable to financing its unitary operations, such interest expense still would have been denied under the interest-offset provision.

In point of fact, however, it is indisputable that petitioner would have been entitled to deduct more interest expense

[5] In this regard, the claim of respondent and its amici that petitioner is attempting to " 'constitutionalize' the manner by which states are permitted to allocate interest expense deductions between taxable and nontaxable income" (Resp. Br. 33) is nonsense. Petitioner has identified a variety of reasonable methods widely adopted by other States that do not arbitrarily and disproportionately assign interest expense to nontaxable income. Petitioner seeks only to eliminate from the broad array of constitutionally acceptable mechanisms California's unique and arbitrary method for allocating interest expense.

from its business income under any of the alternative formulas. For example, if petitioner's interest expense were allocated between its nonunitary dividends and its apportionable business income by the ratio of the nonunitary dividends to its total net income (before deducting interest expense), it would have allocated an average of fifteen cents of interest expense to each dollar of taxable and nontaxable income during the years at issue, an increase of $64 million of deductible interest expense.[6] The results of such an alternative method, which is derived from the undisputed facts of this case, put to rest any suggestion that California's interest-offset provision does not deprive petitioner of a substantial interest deduction.[7]

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[6] Appendix C (App. 3a) sets forth an allocation of petitioner's interest expense based on a ratio of nonbusiness dividends to total net income. As with other similar methods of allocating interest expense (*e.g.*, a net assets method or gross income method), which have been adopted by almost every other State (Pet. Br. App. 1a-22a), this allocation method results in an evenhanded allocation of interest expense to both taxable and nontaxable income.

[7] Respondent's contention that "Hunt-Wesson's endorsement of these alternative formulas is less than candid" because "[i]t does not ask this Court to permit it to recalculate its interest expense deduction by any one of the alternative 'fair' allocation methods," Resp. Br. 35, is untrue and, as respondent itself well knows, "less than candid." Petitioner never would have challenged California's interest allocation methodology, if it had been permitted to allocate its interest expense in the same manner that is permitted in other States. *See* Pet. Br. App. 1a-22a. Moreover, respondent's suggestion that petitioner should ask this Court to recalculate its interest expense in accordance with a reasonable allocation methodology is disingenuous, to say the least. Respondent has stipulated to the refund to which petitioner is entitled should it prevail in this litigation. Second Supplement to Joint Stipulation of Facts (J.A. 31). Finally, respondent's assertion that petitioner "continues to maintain, without hint of compromise, that none of the more than $273 million in interest expense incurred during the years in issue was in any way related to the approximately $75 million of nonbusiness dividends which its investments generated" (Resp. Br. 35) is misleading. Petitioner has maintained, consistent with the stipulated facts, that there was no evidence of any relationship between the disallowed interest expense and the nontaxable income, but it has never suggested that *none* of such interest expense could not fairly be attributed to its nontaxable income under a reasonable allocation methodology. It was respondent's application of the draconian interest-offset provision "without the hint of compromise" that sparked this controversy, not petitioner's alleged intransigence.

Furthermore, when this Court has considered analogous questions, it has likewise endorsed an interest expense methodology that assigns interest between taxable and nontaxable income on a nondiscriminatory basis. Thus the very cases that respondent cites for the settled proposition that "immunity from taxation need not be total, but may instead be limited by charging such non-taxable income with its fair share of related expenses" (Resp. Br. 16) reaffirm petitioner's essential position here: that expenses must be assigned evenhandedly between taxable and nontaxable values. For example, in *United States v. Atlas Life Ins. Co.*, 381 U.S. 233 (1965), this Court sustained a pro-rata methodology for determining the extent to which an insurance company could reduce its taxable investment income by its tax-exempt interest. In so holding, the Court articulated the rule that lies at the heart of petitioner's case: "We see no sound reason, legal or economic, for distinguishing between the taxable and nontaxable dollar. . . . " *Id.* at 249. The same principle applies here: There is no sound legal or economic reason for the interest-offset provision's differential treatment of the taxable and nontaxable dollar, assigning a disproportionate amount of interest expense to the latter. *See also First Nat'l Bank v. Bartow County Bd. of Tax Assessors*, 470 U.S. 583 (1985) (sustaining pro rata deduction of tax-exempt federal obligations from taxable and nontaxable assets).[8]

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[8] For this reason, respondent's attempt to minimize the force of *National Life Ins. Co. v. United States*, 277 U.S. 508 (1928) (Pet. Br. 21-22), is misguided. *National Life* (and its progeny) squarely stand for the proposition, on which petitioner's case rests, that one may not be denied a deduction merely because one receives income that is tax free. That, of course, is exactly what the interest-offset provision does. Moreover, even if some portion of petitioner's interest expense could reasonably be attributed

Respondent's claim that the interest-offset provision is attempting "to plug a destructive tax loophole" (Resp. Br. 12) that allows corporations to invest equity capital to generate nontaxable income while investing borrowed funds to generate taxable income does not justify the adoption of a mechanism that arbitrarily attributes interest expense to nontaxable income.[9] Indeed, the "loophole" is easily plugged, as virtually every other State faced with the problem has plugged it, by assigning "fungible" interest expense to taxable and nontaxable income on an evenhanded basis. Furthermore, respondent's claim that the interest-offset provision is designed merely to "level[ ] the playing field" (*id.* at 28) between debt and equity investments is belied by the statute's operation. Far from "leveling the playing field," by assigning an arbitrary and, here, disproportionate amount of interest expense to nontaxable income, California has tilted the playing field against those who earn nontaxable income.

In the end, California's fungibility argument stumbles on its own premise. If money is indeed fungible, and interest expense cannot reliably be traced to its ultimate use, then it follows that interest expense should be assigned on an evenhanded basis to all of the income to which it is fungibly related. That is precisely what is accomplished by almost all of the generally accepted methods for assigning "fungible" interest expense to income. That is also the approach that this Court has sanctioned when confronted with the question of how interest expense should be allocated between taxable and nontaxable income. By contrast, the interest-offset provision

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to its tax-exempt income under a rational allocation formula, *National Life* would continue to bar a State's denial of the balance of the expense.

[9] It is questionable whether the problem California has identified is properly characterized as a "loophole," since the income that California cannot tax is taxable by the State of the taxpayer's domicile. The stipulated facts provide that petitioner's nonunitary dividends, which were not subject to tax in California, "were taxable by the State of Illinois, Beatrice's state of domicile, during the fiscal years at issue." Stip. ¶ 8 (J.A. 19).

is at war with the concept of fungibility by assigning (and, in this case, overassigning) interest expense to nontaxable income on an arbitrary basis.

D. The Court's "Fair Apportionment" Decisions Have No Bearing on the Issues Raised Here

The indefensibility of the interest-offset provision as a fair method of allocating interest expense to income (even under respondent's "fungibility of money" theory) has understandably induced respondent to shift the focus of its argument from the questions petitioner has raised – whether the interest-offset provision effectively taxes extraterritorial income and discriminates against interstate commerce – to a question petitioner has not raised – whether California's tax is fairly apportioned. Resp. Br. 23-26. Respondent's goal in redirecting the inquiry is transparent: It seeks to place itself under the umbrella of the Court's decisions that have recognized the difficulty of ascertaining precisely what share of a taxpayer's apportionable tax base should be assigned to a State. Because of that difficulty, these decisions have declined to overturn the application of reasonable apportionment formulas to a taxpayer's apportionable tax base so long as the formulas achieve "rough approximation" and do not lead to a "grossly distorted result." *Id.* at 25. The Court's "fair apportionment" decisions, and their forgiving constitutional standards, have no application here for several reasons.

First, there is no support for the proposition that, regardless of the nature of a constitutional challenge to an apportioned tax, the validity of the challenge will be determined by asking simply whether the tax is fairly apportioned. In *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388 (1984), for example, this Court considered a Commerce Clause challenge to New York's fairly apportioned corporate income tax, which contained an export credit for Domestic International Sales Corporations (DISCs) that favored in-state over out-of-state activity. The New York State Tax Commission, like respondent here, sought to deflect the attack on the ground that the tax was fairly apportioned. This Court responded:

> The fact that New York is attempting to tax only a fairly apportioned percentage of a DISC's accumulated income does not insulate from constitutional challenge the State's method of allowing the DISC export credit. New York's apportionment procedure determines what portion of a business' income is within the jurisdiction of New York. Nothing about the apportionment process releases the State from the constitutional restraints that limit the way in which it exercises its taxing power over the income within its jurisdiction.

Id. at 398-99.

Here, too, any suggestion that California's tax may be fairly apportioned is beside the point. Petitioner is challenging the interest offset not because it leads to malapportionment, but because, under the guise of denying a deduction, it assigns to California income that California has no power to tax and discriminates against interstate commerce. If California arbitrarily added ten percent to the income of any taxpayer who earned nontaxable income, it could not seriously defend the tax on the ground that the resulting tax did not create a "grossly distorted result." Nor may respondent defend a mechanism that systematically sweeps nontaxable income into the tax base through an arbitrary assignment of interest expense on the ground that it does not create a "grossly distorted result."[10]

[10] *Amerada Hess Corp. v. Director, Div. of Taxation*, 490 U.S. 66 (1989), is of no assistance to respondent. In *Amerada Hess*, the taxpayer challenged New Jersey's denial of a deduction for windfall profit taxes on the theory that the State was unconstitutionally denying a deduction for an out-of-state expense. But the Court pointed out that "it is inappropriate to consider the windfall profit tax as an out-of-state expense," *id.* at 74, because it was incurred in the course of the taxpayer's unitary business. Here, by contrast, the out-of-state income that is effectively added to the taxpayer's apportionable tax base concededly does not derive from the taxpayer's unitary business. Hence, any analogy between the unitary out-of-state expense in *Amerada Hess* and the petitioner's nonunitary out-of-state dividends rests on a false comparison.

Second, these relaxed standards of constitutional adjudication apply only to apportionment formulas that are not "inherently" (*Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 121 (1920)) or "intrinsically" (*Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123, 133 (1931)) arbitrary. The interest-offset provision does not meet this standard. Unlike income apportionment formulas, which spread income evenhandedly among the States in which a taxpayer does business on the basis of one or more apportionment factors reflecting in-state activity, the interest-offset provision arbitrarily assigns income to a State based merely on the taxpayer's receipt of nonunitary dividends and without regard to any factor or factors reflecting in-state activity. Hence the presumption of correctness that applies to the application of reasonable apportionment formulas has no application here.

In short, this case does not involve a challenge to the application of a theoretically defensible formula to a taxpayer's unitary tax base to determine whether the State is taxing a fairly apportioned "slice" of a concededly apportionable "pie." Rather, it involves a challenge to a theoretically flawed mechanism that looks to admittedly nonapportionable income in determining the amount of a deduction (and, hence, the amount of income) that the State may tax.

E. It Is No Defense That California's Interest-Offset Provision Is "Internally Consistent"

Respondent also seeks to defend the constitutionality of the interest offset on the ground that it satisfies this Court's "internal consistency" test for evaluating the validity of state taxes under the Commerce Clause. It is true, of course, that if a tax is *not* internally consistent – *i.e.*, if its hypothetical replication by every State would burden interstate commerce – the statute is *not* constitutional. *See, e.g., Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984). But it does not follow that if a tax *is* internally consistent, the tax *is* constitutional. Indeed, such reasoning is fallacious both as a matter of logic and as a matter of law.

As a matter of logic, the argument founders on the elementary proposition that the inverse of a statement is not necessarily true. For example, it is true that if an animal does *not* have four legs, it is *not* a dog. But it does not follow that if an animal *does* have four legs, it *is* a dog. Yet that is the underlying "logic" of respondent's analysis.

What is true as a matter of logic is also true as a matter of law. Statutes that are "internally consistent" are not necessarily constitutional. For example, reciprocity statutes, such as those at issue in *New Energy Co. v. Limbach*, 486 U.S. 269 (1988), are "internally consistent." In that case, Ohio offered a tax credit for fuel containing ethanol produced in Ohio or in any State that granted a similar credit for Ohio-produced fuel. If every State had adopted Ohio's scheme, there would be no discrimination against interstate commerce, because the credit would be available in every State. Yet this Court had no hesitation in unanimously condemning the tax as unconstitutionally discriminatory. Quoting its earlier decision in *Great Atl. & Pac. Tea Co. v. Cottrell*, 424 U.S. 366 (1976), in which it had likewise invalidated an "internally consistent" reciprocity scheme, the Court declared that " 'Mississippi may not use the threat of economic isolation as a weapon to force sister States to enter into even a desirable reciprocity agreement.' " *New Energy*, 486 U.S. at 274 (quoting *Great Atlantic*, 424 U.S. at 378). Nor may California.

Indeed, the pernicious consequences of respondent's argument are self-evident. Today California stands alone among the States in arbitrarily assigning interest expense to business and nonbusiness income by an interest-offset mechanism. *See* Pet. Br. 26-28; *Id.* at App. 1a-22a. Virtually every other State assigns interest to business and nonbusiness income by a mechanism that seeks to attribute interest to *related* business and nonbusiness income. *Id.* As a consequence, when California arbitrarily assigns interest expense to unrelated nonbusiness dividends, it is simply not true that "the offset interest expense would be recognized and have the effect of reducing its tax liability in . . . its State of domicile." Resp. Br. 27. To the contrary, other States will allow only the portion of the expense that is *related* to the nonbusiness

dividend, which, as in this case, will ordinarily be considerably less than the dollar-for-dollar offset that California assumes. And this is so whether the interest expense is allocated on a direct tracing basis or by some rational allocation according to the ratio of business to nonbusiness income or the assets producing such income.

II. THE INTEREST-OFFSET PROVISION PLAINLY FAVORS DOMICILIARY OVER NONDOMICILIARY CORPORATIONS IN VIOLATION OF THE COMMERCE CLAUSE

The interest-offset provision discriminates against nondomiciliary corporations for the simple reason that it denies a nondomiciliary corporation, but not a domiciliary corporation, a deduction for interest expense equal to the corporation's nonunitary dividends. The discrimination cannot be justified as a method for matching a corporation's interest expense to its taxable income because, as we have already explained at length, the interest deduction is denied to the nondomiciliary and granted to the domiciliary regardless of any relationship between the interest expense and the nonunitary dividends. Consequently, the denial or grant of the deduction depends entirely on the corporation's domicile in violation of settled Commerce Clause principles.

Respondent does not – and could not – deny our description of the practical effect of the statute. Instead, it seeks to defend the statute by suggesting that the appropriate comparison for Commerce Clause purposes is not between domiciliary and nondomiciliary corporations but "between corporations that operate on borrowed money while simultaneously holding investments which generate income exempt from California tax and corporations that do not hold such investments and devote their entire capital to their business operations. . . . " Resp. Br. 40. The contention has no support in this Court's Commerce Clause jurisprudence.

It is true, of course, that "any notion of discrimination assumes a comparison of substantially similar entities." *General Motors Corp. v. Tracy*, 519 U.S. 278, 298 (1997). In this

case, two corporations identical in every respect except for their State of domicile clearly are "substantially similar entities" for purposes of a discrimination analysis under the Commerce Clause. *See, e.g., South Cent. Bell Tel. Co. v. Alabama*, 526 U.S. 160 (1999). Indeed, if respondent's gerrymandered definition of "substantially similar entities" could inform Commerce Clause analysis, it would invite the very type of "economic Balkanization" that the Commerce Clause was designed to prevent, *Hughes v. Oklahoma*, 441 U.S. 322, 325 (1979), by permitting States to favor in-state over out-of-state corporations under the guise of a constricted classification of "substantially similar entities."[11]

[11] For reasons set forth above (*see supra* pp. 13-15), respondent's defense to the claim that the interest-offset provision is discriminatory on the theory that it is "internally consistent" (Resp. Br. 42-43) has no support in logic or law. Moreover, respondent's Pollyannaish assumption that the discriminatory effects of the interest-offset rule would be offset by similarly discriminatory regimes in other States (*id.* at 43) simply ignores the fact that no other State has an interest-offset regime like California's. *See* Pet. Br. App. 1a-22a. Furthermore, respondent's claim that the "antidiscrimination principle of the Commerce Clause 'has not in practice required much in addition to the requirement of fair apportionment,' " Resp. Br. 42 (quoting *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 171 (1983)), ignores the context in which the Court made that statement. In *Container*, the Court's remarks were directed to the requirement that "[b]esides being fair, *an apportionment formula* must, under the Commerce Clause, also not result in discrimination against interstate or foreign commerce." *Container*, 463 U.S. at 170 (emphasis supplied). These remarks have no bearing on a claim of discrimination, such as petitioner's claim here, that is independent of (and takes no issue with) the constitutionality of the state's apportionment formula. *See Amerada Hess*, 490 U.S. at 75 ("Even if a tax is fairly apportioned, it may discriminate against interstate commerce."); *Westinghouse*, 466 U.S. at 399 (" 'fairly apportioned' and 'nondiscriminatory' are not synonymous terms").

III. RESPONDENT HAS OFFERED NO SERIOUS DEFENSE OF ITS TAX PREFERENCE FOR NONDOMILICIARY CORPORATIONS RECEIVING NONUNITARY DIVIDENDS FROM SUBSIDIARIES THAT DO BUSINESS IN CALIFORNIA

Even if California were constitutionally free to deny petitioner an interest deduction equal to its nonunitary dividends, petitioner would be entitled nevertheless to an interest deduction because of the second constitutional defect in Cal. Rev. & Tax. Code § 24344 – the selective allowance of an interest deduction corresponding to the extent of the petitioner's dividend-paying subsidiaries' in-state activities. There can be little question that California's taxing scheme is unconstitutional in light of the Court's recent decision in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), striking down a similar scheme. Nothing in respondent's brief casts any doubt on that conclusion.

First, respondent's suggestion that this issue is not properly before this Court is preposterous. It was squarely raised in the Questions Presented (Pet. i (Question 2)), and, indeed, has been in controversy throughout this litigation. *See, e.g.*, J.A. 64. Nor is petitioner's challenge "little more than a disguised attack on section 24402," not that this would matter. Petitioner's challenge is directed to the simple and indisputable fact that, under section 24344, it is entitled to an interest expense deduction equal to the amount of its nonunitary dividends *only* to the extent those dividends reflect the subsidiaries' in-state business activity. Whether this limitation reflects other discriminatory features of California's tax code is of no concern to petitioner. Petitioner's challenge is unequivocally focused solely on the discriminatory denial of an interest deduction under Cal. Rev. & Tax. Code § 24344.[12]

[12] As respondent notes, other taxpayers *are* challenging the constitutionality of section 24402, which limits a corporation's dividends received deduction to dividends reflecting income previously taxed by California. *See First Credit Bank & Subsidiary v. Franchise Tax Bd.*, Los Angeles Cty. Sup. Ct., No. BC 205481. The only relevance of section

Second, respondent's contention that the statute is applied in a nondiscriminatory manner because "all dividends declared from income already subjected to California tax are excluded from the interest offset computation" (Resp. Br. 45) is downright silly. That is exactly the point – any foreign corporation that invests in a nonunitary subsidiary doing business in California is entitled to the interest expense deduction and any foreign corporation that invests in a nonunitary subsidiary doing business elsewhere is not.

Third, respondent's effort to distinguish *Fulton* is futile. Initially, respondent seeks to rescue California's statute by reference to its purpose. It contends that the statute survives Commerce Clause scrutiny because it was "intended 'to avoid double taxation at the corporate level of income which has already been subjected to California taxation in the hands of the dividend-declaring corporation.' " Resp. Br. 46 (quoting *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 7 Cal. 3d 544, 548 n.4 (1972)).[13] This allegedly benign intent might protect the statute's disparate treatment of corporations with in-state subsidiaries and corporations with out-of-state subsidiaries from attack under the Equal Protection Clause. For Commerce Clause purposes, however, it is insufficient. It is well established that a determination that a state tax violates the Commerce Clause "may be made on the basis of either discriminatory purpose . . . or discriminatory effect." *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 270 (1984) (citations omitted). The discriminatory effect of favoring investments in in-state over out-of-state corporations is incontrovertible, and this Court in *Fulton* rejected a virtually identical avoidance-

24402 to this case is *descriptive*: it describes those dividends the receipt of which entitles a taxpayer to an interest deduction.

[13] In advancing this argument, respondent implicitly acknowledges that the interest-offset provision, in fact, operates to impose a second tax upon the nonbusiness dividends not taxable by California, thereby creating the need for the exemption. This is in clear contradiction of its earlier statement that the interest-offset provision does not result in the taxation of such dividends. Resp. Br. 36.

of-double-taxation defense pressed by North Carolina. *See Fulton Corp.*, 516 U.S. at 344-46.

Nor does respondent advance the analysis by suggesting that, inasmuch as the dividend-producing income has already been taxed in California, "no advantage is afforded to California subsidiaries over foreign subsidiaries" because "[t]he exemption does nothing more than compensate for the earlier taxation of the dividend-producing income by California. . . . " Resp. Br. 47. The observation is irrelevant to the question before the Court. The question is not whether the interest-offset provision favors the dividend-*paying* corporation; the question is whether it favors the dividend-*receiving* corporation. Plainly it does, because only dividend-receiving corporations with in-state subsidiaries are entitled to the benefit of the interest expense deduction.

Respondent's contention that California's goal of avoiding double taxation "cannot be adequately served by reasonable nondiscriminatory alternatives," *id.* at 48 n.29 – which concedes the essential point that the statute *is* discriminatory – is groundless. If California wants to avoid double taxation of corporations and their subsidiaries, it need only allow a dividends received deduction for dividends received from all subsidiaries, whether or not they do business in California. Only in respondent's California-centric view of the federal system can such a nondiscriminatory deduction be considered as a "loophole," *id.*, since any subsidiary that had not already been taxed in California would likely have been taxed in one or more of the other 45 States and the District of Columbia that impose corporate income taxes. 1 All States Tax Guide (CCH) ¶ 10-050 (1999). Equal treatment of in-state and out-of-state taxpayers, which takes account of burdens imposed by other States, is the hallmark of this Court's Commerce Clause jurisprudence. *See, e.g., Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 192-93 n.6 (1995).

Finally, respondent's attempt to distinguish *Fulton* and to justify California's discriminatory denial of an interest expense deduction to taxpayers investing in out-of-state subsidiaries on the ground that it is "internally consistent" (Resp. Br. 49) fails for the same reason that its "internal consistency"

defense failed with respect to the general denial of an interest deduction for taxpayers receiving nonunitary dividends: merely because a tax is internally consistent does not mean that it is constitutional. *See supra* pp. 13-15 & p. 16 n.11. In this context too, the reason why "internal consistency" is not a *defense* to the constitutionality of a discriminatory statute is apparent. Because no other State has adopted an interest-offset provision like California's, Pet. Br. 28-32; *id.* at App. 1a-22a, respondent's claim that "the level of in-state activity does not affect a corporation's overall tax liability, but affects merely the extent to which interest expense is allocated between sources in and out of California" (Resp. Br. 49) is pure fantasy. In fact, when a nondomiciliary corporation invests in an out-of-state, nonunitary subsidiary, it stands to lose its California interest deduction, on a dollar-for-dollar basis, to the full extent of any dividends paid by that subsidiary, and it will never be able to deduct the amount of interest expense that other States will attribute to California under the non-discriminatory interest expense allocation regimes in force in those States.

CONCLUSION

For the foregoing reasons, the judgment of the California Court of Appeal should be reversed.

Respectfully submitted,

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APPENDIX A

MTC SCHEDULE 1205

INTEREST OFFSET – CALIFORNIA

	______	______	______
Total Interest Expense[1]	______	______	______
Non-Business Portion	(______)	(______)	(______)
A. NET INTEREST EXPENSE	======	======	======
Total Interest Income	______	______	______
Non-Business Portion	(______)	(______)	(______)
B. BUSINESS INTEREST INCOME	======	======	======
C. EXCESS A. OVER B.	======	======	======
Total Non-Business Divident Income	______	______	______
Non-Business Interest Income	______	______	______
Total Deductible Dividends	(______)	(______)	(______)
D. BALANCE	======	======	======
INTEREST OFFSET (lesser of C or D)	======	======	======

TO SCHEDULE 1105

[1] Water's Edge filers who are subject to the foreign dividend interest offset are required to reduce total interest expense by foreign interest expense to offset the foreign dividend deduction.

APPENDIX B

Application of California's Interest Offset Formula To Hunt-Wesson*

		1980	1981	1982	Total
1.	Total Interest Expense	$ 80,490,469	$ 55,101,503	$ 137,413,162	$ 273,005,134
2.	Less: Unitary Business Interest Income (A)	$ 10,217,578	$ 21,389,332	$ 83,920,105	$ 115,527,015
3.	Balance (B)	$ 70,272,891	$ 33,712,171	$ 53,493,057	$ 157,478,119
4.	Less: Nonbusiness Dividend Income (C)	$ 26,718,620	$ 29,482,367	$ 19,022,617	$ 75,223,604
5.	Balance (B minus C)=(D)	$ 43,554,271	$ 4,229,804	$ 34,470,440	$ 82,254,515
6.	Total Interest Expense Subject to apportionment in California (A plus D)=(E)	$ 53,771,849	$ 25,619,136	$ 118,390,545	$ 197,781,530
7.	Interest Offset (Lesser of B or C)=(F)	$ 26,718,620	$ 29,482,367	$ 19,022,617	$ 75,223,604
8.	Business Income (G)	$ 500,434,037	$ 487,922,753	$ 575,711,747	$ 1,564,068,537
9.	Amount of Interest Expense Allocated To Each Dollar of Nonbusiness Dividend Income (F/C)	$ 1.00	$ 1.00	$ 1.00	$ 1.00
10.	Amount of interest Expense Allocated to Each Dollar of Business Income (E/G)	$ 0.1075	$ 0.0525	$ 0.2056	$ 0.1265
11.	Percentage Increase in Interest Expense Allocated to Nonbusiness Income Under Interest Offset	830%	1805%	386%	691%

* This table is identical to the table set forth in the appendix to Brief for Respondent, Resp. Br. at 1a, except lines 8-11 have been added. Line 8 sets forth petitioner's total business income; the source for this information is at Clerk's Transcript ("CT") p. 83. Lines 9, 10, and 11 are merely computational and do not reference the record.

APPENDIX C

Use of Net Income Method to Allocate Interest Expense To Business and Nonbusiness Income

		1980	1981	1982	Total
1.	Total Interest Expense (A)	$ 80,490,469	$ 55,101,503	$ 137,413,162	$ 273,005,134
2.	Nonbusiness Dividends (B)	$ 26,718,620	$ 29,482,367	$ 19,022,617	$ 75,223,604
3.	Unitary Domestic Net Income (C)[1]	$ 458,872,375	$ 436,934,025	$ 521,709,407	$ 1,417,515,807
4.	Unitary Foreign Net Income (D)[2]	$ 37,425,467	$ 43,625,313	$ 50,348,114	$ 131,398,894
5.	Total Unitary Net Income Before Deducting Interest Expense (A+C+D)=(E)[3]	$ 576,788,311	$ 535,660,841	$ 709,470,683	$ 1,821,919,835
6.	Ratio of Nonbusiness Dividends (B) To Total Unitary Net Income (B/E)=(F)	4.632310%	5.503924%	2.681241%	4.128810%
7.	Interest Expense Allocable To Nonbusiness Income (A x F)=(G)	$ 3,728,568	$ 3,032,745	$ 3,684.378	$ 11,271,863
8.	Interest Expense Allocable To Business Income (A-G)=(H)	$ 76,761,901	$ 52,068,758	$ 133,728,784	$ 261,733,271
9.	Amount Of Interest Expense Allocable to Each Dollar of Business Income Under Income allocation (H/(E-B))	$ 0.1395	$ 0.1029	$ 0.1937	$ 0.1498
10.	Amount Of Interest Expense Allocable To Each Dollar of Nonbusiness Dividends Under Income Allocation (G/B)	$ 0.1395	$ 0.1029	$ 0.1937	$ 0.1498
11.	Amount of Interest Expense Allocated To Each Dollar of Nonbusiness Dividends Under Interest Offset	$ 1.00	$ 1.00	$ 1.00	$ 1.00
12.	Interest Expense Allocable to Nonbusiness Income Under Interest Offset	$ 26,718,620	$ 29,482,367	$ 19,022,617	$ 75,223,604
13.	Percentage Increase in Interest Expense Allocated to Nonbusiness Income Under Interest Offset	617%	872%	416%	568%

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[1] Clerk's Transcript ("CT") at p. 85. (Includes DISC Income and Nonbusiness Dividends).

[2] CT at p. 85. (Includes Nonbusiness Dividends).

[3] Interest expense (A) is added back to Total Unitary Net Income to arrive at Net Income before deducting interest expense.